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Meeting of the Federal Open Market Committee

April 1, 1986

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, April 1, 1986 at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Guffey 1/
Mrs. Horn
Mr. Johnson
Mr. Melzer
Mr. Morris
Mr. Rice
Ms. Seger
Mr. Wallich

Messrs. Boehne, Boykin, Keehn, and Stern, Alternate
Members of the Federal Open Market Committee

Messrs. Black, Forrestal, and Parry, Presidents of the Federal
Reserve Banks of Richmond, Atlanta, and San Francisco,
respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, 2/ General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Balbach, J. Davis, R. Davis, T. Davis,
Kohn, Lindsey, Prell, and Siegman,
Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System
Open Market Account

Mr. Cross, Manager for Foreign Operations, System
Open Market Account

1/ Left meeting after action to approve minutes of February meeting and
reentered before action to adopt domestic policy directive.

2/ Entered meeting before action to adopt domestic policy directive.

4/1/86

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Mr. Coyne,^{1/} Assistant to the Board of Governors
Mr. Roberts,^{1/} Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International
Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant,
Board of Governors

Messrs. Broadus, Lang, Rolnick, Rosenblum, Scheld,
Scadding, and Ms. Tschinkel, Senior Vice Presidents,
Federal Reserve Banks of Richmond, Philadelphia,
Minneapolis, Dallas, Chicago, San Francisco, and
Atlanta, respectively

Mr. McNees, and Ms. Clarkin, Vice Presidents, Federal
Reserve Banks of Boston and New York, respectively

^{1/} Entered meeting after action to approve minutes of February meeting.

Transcript of Federal Open Market Committee Meeting of
April 1, 1986

MR. WALLICH. I nominate Paul Volcker as Chairman. Is there another choice? I take it that the motion is approved.

CHAIRMAN VOLCKER. I haven't heard any objection. We need a Vice Chairman, too.

MR. WALLICH. I nominate Gerald Corrigan to serve as Vice Chairman of the Committee for the year ahead. Is there a second?

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection, Mr. Corrigan will be Vice Chairman.

MR. BLACK. You didn't give us enough time, Mr. Chairman. We'd have objections to that one!

CHAIRMAN VOLCKER. We have a list of [proposed] officers. Do you want to read the list, Mr. Bernard?

MR. BERNARD.

Staff Director and Secretary, Stephen Axilrod
Assistant Secretary, Normand Bernard
Deputy Assistant Secretary, Nancy Steele
General Counsel, Michael Bradfield
Deputy General Counsel, James Oltman
Economist, James Kichline
Economist (International), Edwin Truman

Associate Economists from the Board:

Donald Kohn;
David Lindsey;
Michael Prell; and
Charles Siegman.

Associate Economists from the Reserve Banks:

Anatol Balbach, proposed by President Melzer;
John Davis, proposed by President Horn;
Richard Davis, proposed by President Corrigan;
Thomas Davis, proposed by President Guffey; and
Alicia Munnell, proposed by President Morris.

CHAIRMAN VOLCKER. Do we have a motion, if that's appropriate?

VICE CHAIRMAN CORRIGAN. So moved.

CHAIRMAN VOLCKER. Is it seconded?

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. Do we have a motion on the redesignation of the New York Reserve Bank as agent [for the System Open Market Account]?

SPEAKER(?). So moved.

CHAIRMAN VOLCKER. I did hear a second someplace!

MS. SEGER. I'll second.

CHAIRMAN VOLCKER. Without objection. We have Mr. Sternlight and Mr. Cross as Managers, with the concurrence of the New York Bank I assume. No objections to that. You have a series of what are listed on my agenda as policy instruments. We renew those once a year. I assume everybody has had a chance to look at them and I don't know of any questions being raised. With no objections, those are approved. There's one item that may not be on your agenda. We need one member of the Committee and an alternate to serve for Freedom of Information appeals. I understand this is not terribly burdensome; there haven't been any appeals from 1978 to 1985. But there is now an appeal pending, I understand. Governor Rice serves in that function with Governor Johnson as an alternate for the Board of Governors, and it may be convenient just to have them also serve for the Committee if that's all right with them and all right with the Committee. Hearing no objections--apparently there's an appeal on which you will have to rule. Now we're through with the annual organizational work. We can go to foreign currency operations, Mr. Cross. Oh, wait a minute! I'm sorry. We have to approve the minutes [of the previous meeting]. Is there a motion on the minutes?

MS. SEGER. I'll move them.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. Mr. Cross.

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any questions or comments?

MS. SEGER. Did you see the article in The New York Times Sunday by Bergsten suggesting that the yen should appreciate still further to about 150?

MR. CROSS. Well, Bergsten has been saying that for a long, long time. If you look strictly at trade considerations and competitive considerations, that's what seems to be influencing his thinking. But of course, the other side of the question is that there are a lot of other elements that enter into the balance of payments other than trade--particularly these capital movements. That's why I mentioned the point about the continued narrowing of the interest rate differentials. That's the other side of the problem in this.

MS. SEGER. You don't think he has a very typical view then?

MR. CROSS. Well, no. I would say that if you just look at the trade position and the competitive position you can come to one conclusion about where the dollar ought to be. Obviously, we still have a very substantial trade deficit. I think all the economists would agree that we haven't begun to see much of the benefits of the exchange rate changes that already have taken place. And that would provide some considerable improvement to our trade position. But we have an enormous trade deficit to deal with. If you're looking at it strictly from that viewpoint, you could persuade yourself that a

[unintelligible] very substantial, and even the very large devaluations and depreciations that we've seen are not going to eliminate the trade deficit. But you can also argue that you can't expect to eliminate all of this huge trade deficit purely by exchange rate moves. There have to be other things in there, such as growth in the other countries. And you also have to watch very carefully the effects of this on capital flows and whether the kind of exchange rate movements he's talking about may lead to great problems for us on the capital side.

CHAIRMAN VOLCKER. You can quote some economists, or one anyway, who says the rate has to get down to 100 yen to the dollar.

MS. SEGER. Ooh!

CHAIRMAN VOLCKER. Not right tomorrow, but he kind of makes it tomorrow. That's the most extreme.

MS. SEGER. I thought 160 was a little extreme; 100 is worse.

CHAIRMAN VOLCKER. Any other comments or questions? We haven't had any transactions.

MR. CROSS. No, we haven't had any transactions.

CHAIRMAN VOLCKER. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Questions?

MR. MELZER. Peter, there's no evidence in the funds market of the change to daylight overdrafts? I guess with the quarter-end--

MR. STERNLIGHT. It has been smothered over by the impact of the quarter-end, as you mentioned President Melzer. But our impression, both from seeing that activity on Thursday and from a number of conversations with funds managers, is that it was no great problem. I think they saw it coming and were pretty well prepared for it. We did get the sense that some of the rise in excess reserves in the past few months was already foreshadowing this greater attention to the overdraft potential.

VICE CHAIRMAN CORRIGAN. Yes, there was some suggestion that the problems that occurred on Thursday may have been related to the caps, but that was not true. One of the big banks had a CHIPS problem that kept us up late again, but it had nothing whatever to do with caps.

MR. JOHNSON. Peter, what's the normal spread between the funds rate and the 3-month bill rate? It's about a point now, and I just wondered.

MR. STERNLIGHT. Well, it normally would be less than that. I think it's fair to say that bills are currently priced with an expectation of the funds rate being lower than the recent 7-3/8 percent--call it, on average maybe 7-1/8 or 7 percent, or something like that. I'm not sure there's any one single figure that is normal,

but I think the spread now is toward the wide side of what has been a typical range. It maybe centers around 1/2 a point or something like that.

CHAIRMAN VOLCKER. If there are no other questions, we will turn to Mr. Kichline. Oh, wait a minute! We have to ratify the transactions.

VICE CHAIRMAN CORRIGAN. I'll move it.

MS. SEGER. Second.

CHAIRMAN VOLCKER. Without objection. Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Jim, I was curious as to why you're projecting further depreciation of the dollar over the last Greenbook. Is it basically lower interest rates, or what?

MR. KICHLINE. Do you mind if I let my colleague answer?

MR. TRUMAN. It's partly just in recognition of the fact that the dollar had already reached a lower level than we were projecting at the time of the last Greenbook. The other part of it is that, with the lower interest rates, we felt that it made more sense to assume somewhat more depreciation.

MR. MELZER. You assume 20 percent over the year--

MR. TRUMAN. Most of that, or half of that, we've already had.

MR. MELZER. What about 1987?

MR. TRUMAN. [Another] 5 percent. In 1987 the level at the end of the forecast period is roughly 10 percent lower than we had [in the last Greenbook].

CHAIRMAN VOLCKER. You are using the assumption of \$16 for the oil price. It's an area where nobody knows. But what would the price of oil sold in the United States today be? Do you have any idea?

MR. TRUMAN. The posted prices, I think, are a little less than that now; my understanding is they are in the \$15 or \$16 range. Mike says \$12-\$15. That's not the spot price but the price at which the large companies will buy.

CHAIRMAN VOLCKER. Well, this is the time for any commentary that the Committee members might want to make on the business scene. Mr. Boehne.

MR. BOEHNE. I think this is one of those times when you have to decide whether you trust what you can see and touch here and now, or whether you trust your ability to look ahead. Normally, I come down on the side of trusting what I can see here and now. And what I see is clearly modest growth: not terrible, not great, but somewhere

in between--very unspectacular. But I think this is not a normal time. Therefore, I am inclined to put more weight on what we think is going to happen down the line. Jim has ticked off the familiar reasons for that; but it does seem to me that this is a very unusual loading of the gun with a lot of economic fire power. We have a number of things coming together that are rather unusual. The drop in long-term rates just since the beginning of the year has been around 200 basis points. Now, we know that takes a lag to affect the economy. We are seeing the effect where one would expect to see it first: in the housing market. The value of the dollar has shown a big drop of 30 percent; there's not a whole lot [yet] to see there, but at least some of the people in my District say that while the orders are not coming in, certainly the interest from foreign buyers is there and they see the beginnings of that process. A factor which was not mentioned is the huge run-up in stock prices. We have had a 25 percent run-up in stock prices this year and that, to say nothing of oil prices, has to have a positive impact on consumer spending. Admittedly, we are in a sluggish period; there isn't a lot of hard evidence to hang one's hat on. But it just seems to me that we have this confluence of factors that are so large and potentially so powerful that I come down on the side of thinking that the second half of the year will be a good bit stronger than the first half.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. One aspect that has not been mentioned, with respect to lower interest rates and their effect on housing, is the tremendous amount of refinancing that is going on. In terms of anecdotal evidence, I have heard of some of our branch directors talking in terms of having 6, 8, 10 people on the phone just to take names and say: We'll call you back about your request. In due course I think this is going to affect cash flow of consumers quite significantly. An interesting comment we picked up from a retailer was that he felt that was a factor that was really holding down retail sales in the short run as people incurred the front-end costs of refinancing. And, of course, the benefits in terms of the cash flow will be spread out over time. I would say in general that in the Eighth District the situation looks pretty good. We have the same mixed picture but some retailers we talked to have seen gains of almost 10 percent on a year-to-year basis in their sales. Auto sales are clearly slow, although the manufacturing that we have in our District seems to be in models that are not backed up in terms of inventories, so there is not an anticipation of big employment cutbacks there. In terms of new housing, again, that is somewhat mixed. But in the better areas, St. Louis and Louisville in particular, home builders are looking for 15 to 20 percent year-to-year gains. I would say the same thing that Ed was saying: It's strange that the data we have seen lately on the economy and how it is doing right now are quite poor, and yet I sense in just talking to people that in general there is a lot more confidence about the outlook right now than there was a month or two ago when we were seeing much better current data.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I agree both with Ed and Tom. I am puzzled as to why we haven't seen more strength in the economic numbers. If someone had told me four months ago where oil prices would be and where

interest rates would be today. I certainly would have predicted a different overall level of economic activity than we find today. I continue to expect strength as I look around me in the District. I see a reasonable amount of confidence in the District; nobody is complaining, really. Both the fall in the exchange rate and the lower interest rates are expected to have some spillover into the heavy capital goods industry by the people in those industries in my District. In the steel industry we have seen an improvement in margins and orders, which may be related to labor negotiations even though they are done company by company this year. There are old habits of purchasing agents that still may be in effect, so we don't know how real that is in the steel industry at this time. Our bankers are reporting, as are Tom's, this extremely high level of activity. In the Fourth District it is more in the refinancing area than the new building area. We see that heavy refinancing on the commercial side as well. Again, the new activity in that area is not so strong where our builders are expressing more and more concern about the overhang. All in all, I guess I agree with this general attitude of confidence that I see around my District. I continue to expect strength in the economy, so I don't know whether to characterize my stance as watchful patience or watchful concern. On the concern side, I think that we will have some time to react if the economic numbers come in weaker in the future than I expect. Maybe [unintelligible] is all but the municipal sector; those folks aren't very happy with the prospect of the federal budget deficit reduction.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I would describe activity in the Sixth District as improving since the end of the year. We did have a downturn in the fourth quarter, but in general things are looking up and I think the outlook is quite promising. What perhaps is more interesting and more encouraging is the fact that growth would seem to be more balanced as the manufacturing sector, particularly textiles and apparels, get some of the benefits of a declining dollar and lower interest rates. Employment is generally up around the District, and unemployment is down except in the energy stricken area of Louisiana where I understand that the unemployment rate is now the highest in the United States. The services sector continues to be very good. The weak spots in addition to energy, which is affecting basically Louisiana and southern Alabama, are in the agricultural and commercial real estate sectors. We have increasingly high vacancy rates in the major cities of the Southeast but, interestingly, the building continues to go on. Where there has been some slackening of commercial real estate development, it seems to have spilled over into the light industry development.

In a more general sense we have not changed our outlook very much; I agree with the others who said that the current information looks a little disappointing but there seems to be an awful lot in the pipeline that would indicate that activity in the second half of the year is going to be considerably better. We basically agree with the Greenbook. I think that some of the disappointment that we are seeing in the numbers is due to the cutbacks in oil-related activities and sharp price cuts before the stimulus of those lower prices gets into the pipeline. The business people that I talk to around the District are extremely optimistic, and I stress "extremely." I don't hear any pessimistic talk at all. Toward the end of the year, just after

Christmas, people were beginning to murmur a little about a national recession. I hear nothing at all about that; people seem to be paying a lot of attention to the low energy prices, the stock market rally, and the bond [market] rally. So there is a good deal of confidence. Whether that will spill over into increased business fixed investments, I think it is a little early to tell. The other thing I hear less about these days is the impact of the declining dollar; people are not talking about that as much. We do hear sporadic reports of higher prices; we heard from someone the other day, for example, who indicated that [prices of] imports of machinery are beginning to increase. This is machinery from Japan and due to the fact that this contact is now locked into that Japanese market he finds this very disturbing. But these reports of higher prices are very, very spotty. In general, things in our area are pretty good, except for the one or two areas related to energy and agriculture. In terms of a policy prescription, all of this would indicate to me that perhaps we ought to sit back and pause for a little while.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Mr. Chairman, although recent statistics certainly present a mixed picture of the economy, I believe that the fundamentals will produce a relatively strong pickup in the second half. Our forecast for the second half of the year is a little less robust than the Board staff's forecast, but I think that is due to the fact that we do not have the dollar declining as sharply as the Board staff's forecast does. Plus, we do not have the same term structure adjustment that produces as low long-term rates as in their forecast. In any case, we are expecting real growth to average roughly 3 percent for 1986 and a similar growth rate for 1987. Our inflation rates are quite similar. We don't have as much of an increase in inflation in 1987 but I think that again is probably due to the difference in assumptions about the value of the dollar between us and the Board's staff.

As for developments in the District, I think there is basic strength in the Twelfth District but the picture is still somewhat mixed. We do have weakness continuing in agriculture, and energy has imparted a lot of weakness in certain areas of California and has produced very bad effects in Alaska. But in the forest products area, where we have had nothing but weakness in the last several years, we are beginning to hear more optimistic talk; and even in agricultural there is some improvement, I think, particularly in those areas such as almonds and wine where there are export markets that are of some significance. The employment picture in California, I would interpret as being relatively good. There have been steady gains in employment in California. We have seen a very erratic picture for the growth of the labor force and that has caused the unemployment rate to jump around most recently from 5.8 to 7.2 percent. But that is solely the effect of changes in the labor force and employment continues to rise. As for other areas of strength in the Twelfth District: construction is quite strong; residential construction and aerospace remain strong; and commercial aircraft orders throughout the District--Washington and California, in particular--are quite strong. One small comment on Tom Melzer's point: We are seeing refinancings that oftentimes involve a loan that is somewhat larger than the existing loan. In addition to that, there are a lot of lenders who will fold the points into the

loan itself. So, I don't know how much of a cash flow bind refinancing is in the state of California.

CHAIRMAN VOLCKER. It seems to me that I read something to the effect that Alaskan oil begins closing [down] when the price gets down to around \$10 or so. The price is getting down to around \$10 or so. Do we still fear that?

MR. PARRY. I think that Alaska is a disaster situation.

CHAIRMAN VOLCKER. Well, a lot of that is revenue for the government.

MR. PARRY. That's right.

CHAIRMAN VOLCKER. At these prices is there talk of actually decreasing production?

MR. PARRY. I haven't heard of any.

MS. HORN. We have Standard Oil in Ohio and of course they have a big North Slope investment; they are not talking yet about decreasing production there. They have some major capital expenditures--they are halfway through a four-year program that they are considering stopping in its tracks--that they are meeting on that these days. They haven't made that decision yet. But they haven't yet talked about production cutbacks. They have certainly talked about how the state of Alaska is going; it is just like dealing with a foreign government, they say.

CHAIRMAN VOLCKER. I hate to raise disconcerting thoughts when I hear about these strengths in the second half of the year, which I can understand. It is a popular forecast these days. But what would happen if OPEC really got its act together and we suddenly found oil prices going up in the second half of the year instead of down? That is not a very popular view these days, but there are some people who hold it; I don't know what the implications are. We don't know whether they're going to do it, much less the implications, but I am not sure that we can assume lightly that there is no possibility of that.

VICE CHAIRMAN CORRIGAN. One thing that it would clearly do, if it did nothing else, is change the bond market psychology in one heck of a hurry.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. In our part of the Midwest, the situation also seems to be improved for the three familiar reasons that Jim enumerated. I think the fundamentals are better and I think they have been and will be enormously helpful. As I talk to people, I have sensed a significant improvement in tone and attitudes over the last couple of months. I hate to mention the agricultural situation one more time but I guess I feel compelled to. I had hoped really that the situation in 1986 was going to be better than in 1985 but I am changing my view on that. The rate of decline certainly has slowed this year; but I think the year as a whole is probably is going to be worse than 1985. I talked to a very senior guy yesterday who told me

about some land that had traded at \$800 to \$900 an acre, which is the lowest I have heard so far. And even at those low levels, with the present level of commodity prices, this land will just barely [unintelligible] cash flow. The exchange value of the dollar is helpful, of course, in the agricultural sector but the trade patterns are largely in place and are very, very tough to change--certainly so soon. So that won't be quite as helpful as might have been expected. The agricultural equipment business is going to be very tough this year. Inventories at the dealer level are extremely high; they're just not moving, and pricing is wicked. So the implement people are continuing to lay off [workers] and to curtail their production, and they are going to have a tough year. The government programs certainly are helpful but they are also very confusing. There is a new industry developing in the Midwest: consultants who hold meetings and try to explain the various agricultural programs, which are very confusing, to the farmers. Those programs are helpful, but when you break it down on a per farm basis, particularly in Iowa which is a corn area, the per farm assistance provided by government programs isn't as great as one might have expected.

Just to add our comments about mortgage refinancings: One of our directors last week characterized this year as the year of the mortgage refinancing. He quantified the difference in monthly payments between a 14 percent loan and a 10 percent loan on a mortgage loan of some size. And in terms of the monthly payments it really does amount to a significant amount of money, which certainly ought to be helpful for consumer spending. In his view, any loan at a rate of 11-1/2 percent or over can be profitably refinanced. But there are perhaps two negative aspects of this. First, he suggested that the impact of this on the thrifts is going to be very very tough; that yield on the asset side of their balance sheets is going to go down significantly and the liability side may not be quite structured to deal with it. Secondly--and I think we are beginning to see this--because of the very heavy volume of refinancing going on, it is going to be tougher to get financing for new homes. This potentially could have a bit of an adverse effect on new home sales. But as we consider the overall situation, I think my comments will be similar to those of others: that the outlook continues to be positive and that the second half of the year ought to show an improvement over the first half.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, I think the animal spirits are rising in New England. Our computer industry went through a difficult adjustment last year. We had a decline of 12 percent in employment in the computer industry in Massachusetts last year, but that seems to be turning around. The companies are hiring again, in part because they're beginning to make sales in Europe again. Asked if this is a function of the change in the dollar, the response is "no" because they haven't changed their prices in the European currencies; it reflects the improvement in conditions in Europe. With respect to your conjecture about oil prices, I think that we have been waiting for a long time for the U.S. bond market to begin to reflect the current rate of inflation. Expectations don't change very readily in the bond market; but once they do, I don't think they change back very readily either. I think the bond market could accommodate the kind of limited upward movement in oil prices that we are likely to see. So, while I would agree with the general configuration of the

Board staff's forecast for a strong second half, if the forecast is wrong, I think it is likely to be wrong because it is too conservative. I think the errors are likely to be on the greater growth side rather than the lesser.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Well, Chairman, conditions in our District continue mixed. I won't go through the by now familiar problems in agriculture and in our small energy patch and so forth. I think those are similar to the problems experienced in those sectors elsewhere in the country. The other side of the coin, of course, is that in the metropolitan areas the economies are generally healthy. One thing that is going on in some of the smaller metropolitan areas that hasn't been commented on is the effect of expansion and refurbishment of defense installations. In places in our District, like Rapid City and Great Falls and Grand Forks, there is a fair amount of that kind of work under way and it matters in places like that.

VICE CHAIRMAN CORRIGAN. They are sitting next to the copper mines.

MR. STERN. We, too, are seeing a tremendous amount of refinancing of mortgages. In fact, some of the lending institutions in the Twin Cities have stopped taking applications and have said that they may resume in the next five or six weeks; but they are just so backed up that for the moment they have stopped. The housing market in the Twin Cities generally is quite strong. Houses are moving very quickly, generally at the asking price, which may imply people are asking too little. But right now at least, things are going very well there. I do expect, as do many others who have commented already, that the overall economy is going to strengthen soon because the fundamentals seem to be positive. I would add to those fundamentals the fact that M1 has grown as rapidly as it has over the past year or more now. This would suggest to me, certainly, an amply accommodative monetary policy and ample liquidity. Liquidity, too, is boosted of course by this refinancing of home mortgages. To some extent, like President Horn, I have been a little surprised by the fact that the economy seems to be continuing to plod ahead while a lot of the financial factors--a lot of the fundamentals--have improved and have improved rather dramatically. But I expect that this separation or decoupling between what has been happening on the financial side and what has been happening on the real side will probably end soon and that we will see strengthening in the overall activity.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, this is turning out to be a very pleasant meeting for me since I frequently have been an outlier in recent months, but I think I will end up somewhere in the middle of the pack. I thought it was real interesting that Jim Kichline--

MR. BOEHNE. You changed my position!

MR. BLACK. Well, I was going to say I was closer to you than anybody else, but I thought you would go into shock if I were to say that, so I refrained from it! It's interesting that Jim Kichline's forecast for real GNP is what we turned in for the Humphrey-Hawkins

report. I know this will probably put Jim into a decline knowing what my forecasting record has been, so let me add that if we were doing it today, we would probably boost that to somewhere in the neighborhood of 4 percent. I think one could make a case that it could be stronger than that, but out of deference to Bob Boykin's friends in the Southwest and the problems they have, I would temper that. But I believe, like Frank Morris does, that the errors are probably going to be on the high side rather than on the low side, given all the financial underpinnings that we have for recovery; declining interest rates, dropping oil prices, and also the apparent housing boom. So I am really rather optimistic. But as you said yourself, Mr. Chairman, it's kind of based on faith because the statistics [don't show it yet]. Every time I think they are coming out solidly on the good side, they jump a little the other way; but I still believe that we are in for a pretty darn good year.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. I, too, am in what I'd call the Boehne camp in the sense that I think the combination of oil prices, interest rates, exchange rates, and stock prices have to give some real boost to the economy in the second half of the year. Ironically, at least for me, I am not quite so sure about the very near-term outlook. I say that because I am not sure that we have fully factored in the adverse short-run effects of the oil situation. In talking to some of the major oil companies that are headquartered in the New York area, I did get the sense that the short-run cutbacks that they are making are very, very substantial. I don't know how you factor those into business fixed investment numbers and so on, but something in my gut tells me that the net effect of that in the very short run could be larger than is built into the consensus-type forecast--and I think the staff forecast is pretty close to a consensus forecast these days.

There are a couple of anecdotal things to report. Like Frank, I am now getting some suggestion that the computer business may be firming, following a pretty soft period of three or four quarters. There is nothing hard and fast but, anecdotally, there is some evidence along those lines. The capital goods side is aggravated by this short-run oil situation and is on the lousy side. Interestingly enough, the suburban New York area is going through a housing boom. Housing prices are rising, at least on an anecdotal basis, very, very rapidly in the suburban New York area. Some of the stories I hear strike me as unbelievable in terms of the rate of price increase on existing homes. But all in all, I think the outlook is respectable. Peter Sternlight and his people take these market pulse beats all of the time, and I was a little surprised in reading some of the material they put together in the last couple of days about more than a couple of market types who apparently are taking a longer view of things and expressing some concern that the underlying inflation situation, despite all of these great numbers we are looking at, really might not be all that good. Presumably, that reflects concern about productivity--General Motors sneaking in 3 percent price increases and things like that--but I was a little surprised. It would not be a surprise for me to say that; I was surprised that other people were saying that.

CHAIRMAN VOLCKER. We will resume our quest for somebody who isn't in the Boehne camp. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I don't have a whole lot to add to the comments I made [at the dinner] yesterday evening, but I'm trying to keep it in perspective at least. It is true that things are not going particularly well down our way. On the other hand, I do think that the press might be overplaying this a little; I'm not sure that it is quite as dire as is being reflected in the press. There is overall economic growth, and it is continuing, but the gains are becoming less and less widely spread. We do have some increase in our non-agricultural employment, but not to the same extent as the rest of the nation. Of course, we picked up that 2-point jump in the unemployment numbers, which we tried to explain a couple of weeks ago --rationalizing at least that it probably wasn't all that great. What I have been reading and hearing since two weeks ago--though I'm not too sure I want to see the March number--is that that 2-point jump was in fact on the high side.

We also have a tremendous amount of refinancing going on. I'm hearing of delays anywhere from 6 weeks to 2 months before one can get a refinancing done. But we also have, particularly in a couple of our metropolitan areas such as Houston and even up in Dallas, a lot of homes still being auctioned off that have been foreclosed on. We have a lot of concern about the thrift industry down our way. There are a lot of problems and, of course, having in the press the report that the Home Loan Bank is bringing in 250 examiners from around the country to help out doesn't give one a lot of confidence that there aren't problems. On the energy issue and the effects on inflation, I would agree with Jim--if I understood him correctly--that the major benefit is in this year and [what will happen] next year remains to be seen. Jerry referred to investment and at least the short-term effects of all of this cutback in energy, oil, and gas. That [sector] has been a very heavy user of investment funds. So at least in the short run, that's not beneficial. I am inclined to want to believe all of these forces that have already been identified that point to better growth in the second half of the year. I certainly hope that that comes about. I have a little reservation in terms of confidence that it's really going to work out as well as it would appear.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I certainly agree that there are these three very basic positive factors that should be helping the economy but, as Jerry and Bob have said, a couple of them can cut either way--particularly the oil price decline. Maybe when we feel good, we tend to emphasize the pluses of that rather than the minuses. Now that we actually are seeing lower gasoline prices at the pumps, that normally would be viewed as a plus for auto sales; yet in the auto market we are seeing constraints coming from the consumer debt burden. I have actually heard some bankers in the last couple of weeks--these groups that pass through town here on their circuit to visit people--say that they are beginning to pay attention to the delinquencies in the consumer credit area and that there may even be a bit of evidence that they are going to look at credit standards. So that can be an offset, or at least a partial offset, to the lower gasoline prices.

Also, I certainly would expect the lower long-term interest rates to help plant and equipment spending; yet at the same time there are these questions about what is going to happen to tax reform. Until the [lawmakers] do something--either kill it or pass it or act

on it decisively--many businesses are going to postpone making decisions on expansion or replacement of equipment because the tax considerations are simply too important to ignore. I can't quantify that, but I think it is a real drag and, in fact, will tend to offset some of the good interest rate news until businessmen and women get a better reading on that.

Despite the lower value of the dollar, import competition is tough in a lot of countries. I hate to admit this, being from Detroit, but not everybody buys a foreign car just because the price tag is lower than the price tag on a domestic car. I don't happen to drive an import but people tell me that there is a quality matter. So, I don't believe we are going to see import competition necessarily knocked out immediately by the change in the exchange rate. It would be nice to think that that would happen, but I don't assume it. Also, in the case of machine tools, I think it was my friend from Atlanta who pointed out that there is more import competition in machinery and machine tools, and I hear that also. In addition, there is this commercial real estate problem that is even spreading into the Midwest. It's no longer just the people down in Bob Boykin's area who like to put up buildings and keep them unoccupied; there are some around the Detroit suburbs and elsewhere, where buildings are popping up like mushrooms on corners. Again, this can be a drag, I think. Therefore, while I am fairly optimistic, I am not as optimistic as I might be if I didn't think there were these somewhat offsetting drags on an otherwise very placid picture.

CHAIRMAN VOLCKER. Who has a good theory as to why General Motors picked this particular time to increase prices?

MS. SEGER. I have been trying to check that. What I heard is that all of his advisors told him not to do it, but that he is very bottom-line oriented and he felt that they could get this much of an increase done at this point. He thought it wouldn't cost them that much in sales, so in terms of their overall profit picture they would actually benefit slightly. They are going to reinstate the incentive programs. My personal opinion is that he probably just didn't take the advice that was being given.

CHAIRMAN VOLCKER. Well, you could have a theory, I suppose, that he raises the base price so he can have a bigger incentive.

MR. BOYKIN. The consumer might figure the financing looks so good that it offsets the price increase.

MS. SEGER. Except the higher sticker stays after the incentive financing goes.

MR. BOYKIN. Who pays sticker?

MS. SEGER. Well, but the--

CHAIRMAN VOLCKER. Dealer cost--

MR. FORRESTAL. The discount [price] is the sticker.

MS. SEGER. The discount [price] is the true sticker, right. I think the price hike is from sticker.

MR. STERN. I haven't been in the showrooms lately, but I am under the impression that prices of imported cars, in fact, have been rising.

SEVERAL. Yes.

MR. STERN. So perhaps a naive reading of this is that it's an opportune time.

MR. MELZER. One dealer for Japanese cars that we talked to indicated that, in addition to the new model year increases, they have had 2 to 3 to 4 percent increases already and they expect at least one, and maybe two, more over the balance of the year.

MR. BLACK. We have one foreign car dealer who puts in a \$1,300 adjustment to market to push the asking price way above list--in addition to the dealer enhancements, which are far above any reasonable cost. So what appears to be the list price to every customer is about \$2,000 above the suggested manufacturer's list. Everybody thinks he is getting a big discount. In fact, people are paying above list right now on many foreign cars. It's very hard to buy them at list.

CHAIRMAN VOLCKER. I thought those days were gone; [unintelligible] discouraging.

MR. BLACK. Well, one would think so, but that's in fact what happens. There is another dealer who gives you dealer list on one side and all of these dealer additions. There are right many of those and they add up to right much. So you are under the impression that the price at the bottom of that is the sum total of all of those, but there's about a \$1,300 discrepancy there. It's just an adjustment to market that he is not really showing honestly.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I would like to join the general euphoria and jump solidly into the Boehne camp. I certainly agree that we are very likely to see strong expansion over the second half of the year. The only reservation that I have is that, as Frank pointed out, the expansion may be stronger than we now expect. We may get a higher rate of growth than is indicated in the staff forecast. What is more [likely] in my view is that the expansion may be spread out in a pattern somewhat different from that in the staff forecast. We may not feel the full impact of all of these stimulative developments until the first part of next year. And the period of fairly strong growth may extend further into 1987 than we now expect. Of course, that has some implications as to what one would be inclined to do about it. So I would say that if the mixed pattern of news that we have been seeing currently continues somewhat longer than one would expect--continues even into the second half of the year--that it is not cause for worry. I cannot remember any time in the recent past when the basic fundamentals pointed so clearly to a strong expansion. And I am prepared to sit back and wait for it and let it unfold.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. Well, I will join the club too. I generally am optimistic about the situation. I also agree that the fundamentals look better than they have in quite some time, even though there are a few uncertainties out there. It wouldn't be out of the question to see OPEC make another run at trying to support the [oil] price. I don't think that they can do it with all the non-OPEC production out there, but I think that they could put some upward pressure on [oil prices]; that's always a risk. To discount that completely would be making a mistake. I do think the fundamentals look better than they have in a long, long time. But at the same time I think that the U.S. economy's future is more in the hands of our foreign trading partners than it ever has been in the last several years. We have not had to rely on that particularly over the last four years, as we had a lot of domestic capacity and we didn't mind running up a trade deficit because we had a surplus in the current account going in--or at least we had a large creditor position. Now, four years down the pike we have a \$150 billion trade deficit and a depreciating dollar; so I think at this point we have to be more careful.

The oil price decline is definitely very welcome. However, the oil price decline benefits our major trading partners, Germany--not Germany directly, but the EC in general--and Japan, more than it does the United States. So, if oil prices have been good for us and have helped our interest rates decline, they also have helped Japan and Germany even more. As a matter of fact, their interest rates should have seen an even more dramatic response. If you look at Japanese rates on the long end of their market, they certainly have. They have a negatively sloped yield curve right now where their long rates are actually below their short rates, indicating to me that there is tremendous pressure in Germany and Japan to pursue lower interest rates just to avoid a potential deflationary cycle in those two countries. So, their fundamentals are stronger than ours. And, unlike the staff, who I think are assuming a further depreciation in the dollar as a source of future growth in this country, I think the way it ought to be and what I would like to see is for our trading partners to move their interest rates lower and maintain the exchange rate alignment that we have now and not see the dollar have to weaken relative to those currencies. We would get our export growth from their growth in demand rather than from the exchange rate shift, and that would obviously be the preferable way to see expansion here in the United States--to see growth pick up in Japan and Germany. Since the elasticities are stronger from the demand effects on exports than the exchange rate effects, and we don't have the negative potential on the inflation side, that's really where we want the growth. I wish I were really optimistic that we would see the kind of flexibility in Germany and Japan that we really need to get that done, but they seem to be fairly satisfied to run generally restrictive policies. There is tremendous pressure, given the fact that Japan faces a negatively sloped yield curve and Germany is not much different than that, for interest rates to go lower there and the exchange rate not have to come under the kind of pressure that we might expect. I think that's what we have to have to get the really good outlook in the future. I am generally optimistic about it but it could come grudgingly; so I am not sure that I would put in the second-half growth effects as strongly as the staff has them because I think that may come a little slower.

CHAIRMAN VOLCKER. I would like to say a word about this foreign situation, particularly with respect to Japan. There is talk in Japan about some kind of stimulative action within a week or so--not on monetary policy particularly, but presumably some kind of budget action--and I don't know what it means. Whether the action is [going to be] significant or trivial, cosmetic or real, I'm not quite sure. But there's going to be something there. I do think--not necessarily as part of that package--that they are debating at the very least, and probably debating in a positive way, whether some further reduction in their discount rate is appropriate in a period of weeks, presumably before the Summit, which is some time in early May. I continue to have some concern about the rate of Japanese growth, although I guess our staff forecast has it a little faster now. Governor Angell.

MR. ANGELL. It seems to me that the uncertainties certainly outweigh the facts we know in regard to the future. It's important that we look at the day-to-day numbers; we may not want to believe them, but we ought to look at them and keep track of them. The monetary aggregates certainly have rebounded in March. If those aggregates continue to move at the March pace, I think that might tell us something different than if growth falls back to the January-February level. I think it's very significant that in the global economy and the domestic economy as well we have dramatic price changes. We end up with winners and losers. Before one concludes too quickly regarding the impact of these kinds of changes, we have to recognize that sometimes the marginal propensity to consume for the winners isn't always the same as it is for the losers. And it seems to me that we do have a severe danger of encountering a world trade contraction in this kind of environment. If that occurs, that's going to impact the export markets and undoubtedly put more pressure on the deflation of international commodity prices. Commodity prices are moving sideways to slightly downward with oil excluded. If those commodity prices pick up speed on the down side, I think that is a very risky pattern. It's a risky pattern not just for agriculture and oil interests in the United States; a lot of the third world countries are commodity sellers. And if we continue to thrust the third world into a position of not receiving any kind of a return on what they have to sell, they're not going to be buying as much as we might expect them to buy. But it seems to me that if we don't stumble, eventually these real balance effects will take place. I'm somewhat concerned that oil prices at some point in time might not do what we want them to do. I suppose all of us would prefer that they move up a bit and stabilize. But we don't have any guarantee of that.

It seems to me that we might need some rather dramatic moves if oil prices were to rebound sharply. So, I think we have to watch things very carefully. I would indicate that I'm much more optimistic--I like to be optimistic about something--than the group now [and] as much as six months ago with regard to the inflation front. It seems to me that it's imperative that we get our inflation rates down in the 2 percent or 1 percent range during this oil price move. If we end up with our staff forecast of inflation, I think that's very bad news for the dollar and our future. So, I'm somewhat optimistic that if there's any indication that prices are going to move in another direction, we could be in for one heck of a deal.

CHAIRMAN VOLCKER. I'm a little surprised on this price forecast that last quarter and this quarter the GNP deflator stays up as high as does in your forecast with the wholesale index going down and the consumer price index going down. You have it going up very narrowly. Would you explain that to me quite simply?

MR. KICHLINE. Well, it's the arithmetic of the first shot of oil [price declines]. As you remember in the old days, if you had a commodity with a very high price deflator such as oil and it's an import, it's a negative and depresses the deflator. Now that we have rebased on 1982 and oil prices are falling, we have a low deflator and they're subtracted out. So in the first round effect you will get a higher deflator from the arithmetic.

CHAIRMAN VOLCKER. This is the implicit deflator you have in this? Does that happen in the fixed-weight deflator?

MR. KICHLINE. Well, yes. In the GNP fixed-weight deflator what you're fixing is quantity, and the price is declining so you are still subtracting both. You're still subtracting imports in the first round effects. Later on you get benefits as those prices show up, for example, in gasoline and you get an effect in the personal consumption expenditures. So, over time, you get something positive.

MR. PARRY. What if you looked at domestic output?

MR. KICHLINE. You get a lower deflator.

MR. TRUMAN. Much lower, if you had that.

CHAIRMAN VOLCKER. Much lower, I guess. All right.

MR. KICHLINE. We have numbers of 2-1/2 percent instead of 3-3/4 percent for the first quarter and 1-1/2 percent in the second quarter as opposed to 2-1/2 to 3 percent. It's a big effect.

CHAIRMAN VOLCKER. We can turn to Mr. Axilrod and--

MR. WALLICH. Could I?

CHAIRMAN VOLCKER. Sure.

MR. WALLICH. It seems to me that we hear a number of elements that are to some degree inconsistent. If we don't get a strong move, which would be to my mind deleterious, we will get a small to moderate move that perhaps will not look very strong, but at least will give us adequate growth of GNP. But the problems in Germany and Japan trouble me a great deal more than what is likely to be happening to us. We're seeing countries that are burdened with difficulties, with balance of payments that they don't want to tolerate. We seem to be willing to have \$100 billion in one and another \$100 billion in the other and say that it makes no difference if other countries are willing to live that way--our way. But I do not believe that they will be. And so I share the feelings that we will some day get into these problems. Those--perhaps not in terms of the numbers but in terms of where the pressures are going to be--strike me as more difficult than our own problems.

CHAIRMAN VOLCKER. As I listen to this, I come away with the view that while the second half of the year may be happy, and everybody has good reason [to believe that] provided the oil situation doesn't snap back at us, I wonder whether the uncertainties presently are being emphasized quite enough. To get this growth in the first quarter and I suppose in the second quarter, we have to have inventory and trade improvement, right? In your projection?

MR. KICHLINE. The second quarter or--

CHAIRMAN VOLCKER. Well, it's certainly true in the first quarter, right?

MR. KICHLINE. Yes. In the first quarter we had final sales flat and 3 percent growth; half of that was imports and the other half was a switch out of CCC, a reduced runoff of farm inventories. So there isn't much there.

CHAIRMAN VOLCKER. The inventory change is all in CCC?

MR. KICHLINE. Final sales are 0.1 in our estimates. Half is reduced imports and the other half is inventories; and about three-fourths of those inventories are a smaller runoff of farm commodities. In fact, CCC purchases are declining. In the second quarter we have final sales and GNP pretty much even; so we don't have much in the way of inventories at all in the second quarter. That's a quarter where we anticipate auto inventories will be running off and we will get some accumulation elsewhere. But essentially, if you look--

CHAIRMAN VOLCKER. And you have the trade balance improving in the second quarter?

MR. KICHLINE. It declines.

CHAIRMAN VOLCKER. Yes, declines means improving.

MR. KICHLINE. Well, there's no contribution to GNP growth.

CHAIRMAN VOLCKER. Oh, it isn't? No contribution?

MR. JOHNSON. I suppose that happens in the second half?

MR. KICHLINE. Well, you said the deficit? Excuse me, in the second quarter we have an estimate of net exports of minus \$130 billion and minus \$115 billion for the year. So it's the second half where we have appreciable improvement in prospect.

MR. ANGELL. Have you taken into consideration any change in desired inventory levels due to a period of falling oil and energy prices?

MR. KICHLINE. Well, I think we have. We actually have, in an historical sense, fairly low ratios of inventories to business sales. What has entered into our thinking, essentially, is that there is absolutely no shortage in most areas--prices are falling. Interest rates have been rather high and are still high; there are all sorts of incentives to economize on inventories. So I think in an historical sense we really have a very mild accumulation over the forecast

period. There are two areas that are problems. In the short run it has been oil and coal, that whole complex of energy [products], and the desire to reduce inventories; the other area that we know about is autos. And there's a major problem there.

MR. JOHNSON. Let me ask one thing. What would the forecast look like in the second half if you didn't assume a further depreciation in the dollar--if you had the same exchange rate and, let's say, you already had a fairly reasonable expansion abroad? Would you say about 4 percent combined EC and Japan?

MR. TRUMAN. No, closer to 3 percent.

MR. JOHNSON. Closer to 3 percent.

MR. TRUMAN. And that's one of the problems. One reason why the trade balance as a whole doesn't improve faster is because we have growth pretty much as fast here, especially in the second half, as we have abroad.

MR. JOHNSON. Yes, but--

MR. TRUMAN. As far as the dollar is concerned, in our forecast for 1986 we're assuming it doesn't have an impact in 1986 on what you're looking at now.

MR. JOHNSON. Okay.

MR. TRUMAN. The way we think about these things--

MR. JOHNSON. It's purely demand.

MR. TRUMAN. What we're seeing in the second half of this year is what we normally have in terms of the dollar, because there's no further decline I think this time--at least the magnitude is very small; you will see some maybe. It's in 1987, as Jim mentioned, that the effects of the [further depreciation]--

MR. PARRY. Would you have inflation the same in 1987 as in 1986 if the dollar didn't depreciate from this point?

MR. KICHLINE. I think there are inflation consequences from this additional 15 percent, but they would be in 1987.

MR. PARRY. That's what I mean.

MR. KICHLINE. That's right.

MR. PARRY. Almost all of that increase in inflation is due to what happened to the dollar?

MR. KICHLINE. Well, in the sense that it's already--

MR. TRUMAN. Also, the oil prices stop going down, so you have that kind of effect.

CHAIRMAN VOLCKER. Well, I was simply going to suggest that there still are great concrete questions about capital spending.

commercial construction, consumer debt load, the governmental budget, foreign growth, the impact of the oil price and other things. I think there are good reasons why the economy isn't looking all that robust right at the moment.

MR. WALLICH. Would you regard it as being much more robust if we had this additional extension in the way the economy is growing and then a year from now it was presumably going downhill?

CHAIRMAN VOLCKER. I don't know as I see it presumably going downhill a year from now if all these nice things that everybody has been emphasizing happen. If we can get through a little--not exactly a valley, but a mesa or something--

MR. RICE. Only that office construction that you point to is relatively permanent. The others are going to--

CHAIRMAN VOLCKER. Maybe that, and not the budget presumably; hopefully, not the budget.

MR. RICE. Yes, we hope the budget deficit is going to fall.

CHAIRMAN VOLCKER. I hope so, but that reduces the [unintelligible] presumably--

MR. RICE. [Unintelligible].

CHAIRMAN VOLCKER. Well, we will see. Let's turn to Mr. Axilrod and then we'll have some coffee.

MR. AXILROD. [Statement--see Appendix.]

CHAIRMAN VOLCKER. [Unintelligible] that you can sit there and talk about interest rates for 10 minutes and not talk about monetary aggregates. I'm not sure whether I'm less confused by the interest rates than I am by the monetary aggregates.

MR. AXILROD. I mentioned the monetary aggregates in passing.

CHAIRMAN VOLCKER. I [unintelligible] that it was in passing. Are there any questions or comments that you want to direct to Mr. Axilrod before the coffee break?

MR. JOHNSON. I just have one, Steve. The last thing you said was that you would expect alternative B to restore some upward tilt to the yield curve. That seems pretty uncertain.

MR. AXILROD. It is uncertain. Also, it has risk potential but I think it is very possible. If the oil price continues to plummet down to \$8 or \$7--it's below \$10 now already this morning--then of course long rates may continue down. But to some degree, they probably have by this time some lower short rates in the future in them than we now have in the market I suppose.

MR. JOHNSON. It just seems to me that alternative B--not that I have any problem with it one way or the other--would flatten out the yield curve rather than have any upward tilt. It probably would put a bit of pressure on the short end of the market. In the

context of current oil prices, I think maybe it would lead to further declines in the long-term yields and a rise in the shorter end.

MR. PARRY. Isn't that the assumption of the forecast? I thought a flat yield curve was the assumption of the forecast.

MR. AXILROD. Well, I think the long rates built into this forecast are actually somewhat higher than we now have in the market.

MR. PARRY. I mean the shape of the curve.

CHAIRMAN VOLCKER. Yes, but the forecast was made up two weeks ago.

MR. AXILROD. That's right.

MR. MELZER. Steve, where do you view the long-run equilibrium real rates to be in the long term?

MR. AXILROD. My view is very simplistic because when you get sophisticated the reality tends to get a little lost in this, I think. It is something like the long-term real growth potential of the economy, about which there's great doubt now. In my own mind I'd put it somewhere between 2-1/2 and 3 percent, give or take a margin of error around that. So the Treasury yield at 7-1/4 percent is very low, if you think the rate of inflation expectations, as in the Hoey survey; is 5 or 5-1/2 percent. [Unintelligible] between Treasuries and corporate bonds opened up here. If you think the rate of inflation expectations isn't properly represented by the Hoey survey-- and I don't think it is--[unintelligible], then if you put the inflation expectations down lower than that 5 percent, of course, your real rates relative to corporates still look somewhat on the high side relative to the expected rate of return. It seems to me it's a very "right on the edge" kind of judgment.

CHAIRMAN VOLCKER. When you hear all this, it makes monetarism sound good!

MR. AXILROD. Well, that's why I did mention the aggregates in passing. It's a very important element.

CHAIRMAN VOLCKER. Any other questions or comments? If not, let's break for coffee.

[Coffee break]

CHAIRMAN VOLCKER. Who would like to express some more detailed policy preferences? You are looking eager, Mr. Melzer.

MR. MELZER. Oh, I have been here writing away. I have been trying to figure out how to get in the word that was mentioned last night--what was it, desiderata?--but I haven't been able to do it.

CHAIRMAN VOLCKER. Desiderata: We want no inflation and good growth and external equilibrium. Those are the desiderata now.

MR. MELZER. Shall I go ahead? I would be in favor of alternative B, maintaining the existing degree of reserve restraint.

That's based on [my view] that the intermediate-term economic outlook is generally favorable, as was discussed today, that we already have an accommodative monetary policy that I think recognizes some of the uncertainties that exist in the short run, and I guess a skepticism on my part still about Gramm-Rudman and what that's going to produce. We didn't talk about that at length today. As I look further down the road, I am concerned a little as we go through the process of adjusting to lower trade deficits and a shift from foreign investment flows or foreign savings to more reliance on domestic savings about the effects associated with that. As we get to that point in time, and it's probably a good 6 to 12 months out before the process really begins, the inflation that naturally would be associated with that process would trouble me; and presumably at that time the effects of lower oil prices pretty much will have washed through the system. It would trouble me at that time if that adjustment process were taking place against the backdrop of a monetary policy that was perceived to be too accommodative, because I think that would simply exacerbate the problem and the interest rate effects of that and so forth. That's looking a little further down the road, but to some extent we have to take that into account in terms of where we are positioned now.

CHAIRMAN VOLCKER. I think that's true. Mr. Black.

MR. BLACK. Mr. Chairman, a lot of the commentary one sees in the press and elsewhere suggests that this reduced inflationary rate gives us an opportunity to stimulate real economic activity without reigniting inflation. I think we might well get away with that in the short run, but I would be quite concerned about an approach such as that in the long run. The effects of the oil price decline are not going to last forever; once they are behind us we are going to be exposed to the risk that we will have a renewed outbreak in inflation, particularly if the economy is growing strongly and the dollar is still dropping. I think we need to keep that in mind in establishing our policy; indeed, I would like to propose something I think Governor Angell came very close to saying a while ago--that rather than look at the current situation as a chance to stimulate the economy, we look at it as a chance to consolidate these excellent gains that we've made on inflation in recent years in the hope that somehow or another that will give us lasting price stability and a chance for sustainable growth in employment and production over the long run.

With those thoughts in mind, I would come out the same as Tom Melzer did: "B" with a \$300 million borrowed reserve objective, with the federal funds rate expected to be in the neighborhood of 7-1/4 to 7-3/8 percent. I would be quite happy, as you might suspect, if we got the kind of M1 growth embodied in "C," but I think we probably ought to leave money market conditions where they are for the time being. I think it is important, though, as we move ahead--from the standpoint of our longer-run credibility--that we try to hold M1 closer to its long-run target than we succeeded in doing last year, unless there is a definite weakening in the economy or a continued decline in the velocity of M1. For that reason and since M1 is right close to the top of its range--in fact, a little above it--I would be inclined to indicate a greater willingness toward restraint than toward easing in this intermeeting period. Just one comment: I am suggesting the \$300 million borrowed reserve target on the assumption that the discount rate is unchanged. If the Board should decide to cut that, under our present operating procedures we would expect the

federal funds rate to move down by roughly a commensurate amount. That to me would be an easing of money market conditions, or "reserve restraint" I guess is the term we use. So, if we should do that, I think we would want to take another look at that borrowing target.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, you outlined some uncertainties and risks in the outlook. Uncertainties are always with us and I suppose one has to take those into account. But in spite of those uncertainties, I think there are some very significant factors at work in the economy that are going to accelerate economic activity in the second half of the year. For that reason I think we ought to take this drop in oil prices as a fortuitous event that will continue to lower inflation and we ought to seize this opportunity to translate that into some kind of permanent improvement in the underlying rate of price increases. So like Mr. Black, I would like us to take this opportunity and not dissipate it in any way by an easing of policy. And I think that an easing of policy would do just that; it would give the markets the wrong impression about how we feel about inflation. So, I would not want to see any easing of policy at this time. I certainly don't see any reason to tighten either, particularly in view of the international situation and the value of the dollar. So, I would prefer to keep policy pretty much where we are, on an even keel without a tilt in either direction. I am a little unhappy about what M1 is doing at the moment, but I guess M2's performance makes M1's performance a bit more palatable. If market rates were, of their own accord, to back up a little--if the markets found that they had perhaps overreacted to this ebullience that is going on--I wouldn't want to resist that upward drift in rates. Again, where I would come out, Mr. Chairman, is to try to consolidate our position with respect to inflation, keep inflationary expectations damped, and keep policy about where it is. That means alternative B, in my mind, with borrowing of about \$300 million.

CHAIRMAN VOLCKER. You mentioned, understandably, a concern about getting this break in oil prices converted maybe into some permanent progress or some further progress against inflation. That's a goal I suppose we would all share. The problem there seems to me to be: How does one ratchet down somehow the cost pressures in the services side of the economy? The manufacturing side is doing pretty well except for this--Martha Seger is our representative of Detroit--General Motors [price increase], which I don't like because--

MS. SEGER. I agree with you.

CHAIRMAN VOLCKER. --it's part of a pattern of price and wage increases reverting to normal. But in general, in manufacturing, in construction, and in some other areas--certainly, commodity prices are depressed--it all looks pretty good. How do we convert this better short-term price performance into some kind of ratcheting down for all that long series of service prices where the economy is doing pretty well and the wage and salary [increases] seem to be stuck at about 5 percent or maybe a little more? I don't know.

MR. JOHNSON. Even if those don't go lower, if you consolidate the oil price decline and don't let other relative prices

go higher than they currently are, you have a ratcheting down of the general price level. In other words,--

CHAIRMAN VOLCKER. A ratcheting down of the levels, but I don't know that you have a ratcheting down of the trend.

MR. JOHNSON. You would slow the inflation rate. It's just that if we try and hold monetary policy constant and let the oil prices decline, one would expect other relative prices to rise and the general price level to remain unchanged. But if we stop that, if we don't let other relative prices show gains to offset the oil price declines, then I think we have ratcheted down prices.

MR. MORRIS. I don't think we can do much to reduce the rate of inflation in the services sector until the next recession. It seems to me that if we are successful in preventing the inflation rate in the services sector from rising while the economy is still in an expansion phase, we have done pretty well.

CHAIRMAN VOLCKER. Well, it has done something; I don't disagree with that. But ideally, if we had a better inflation performance for a year, let's say, and that gets built into salary and other behavior in the services area to a degree, that's what you would like to see happen. If the consumer price index is running 2 percent or so, a 5 percent wage increase looks pretty big given the productivity increase. I am not sure if it looks big to the people giving it or receiving it.

MR. ANGELL. Over a period of time, the inflation rate in the services sector is going to be much slower to adjust to monetary scarcity than it is in the commodity sector because we have too many established techniques for maintaining these rates of inflation, not the least of which is government. There continue to be areas in which, unless you put pain on government, you don't stop the wage increases in government.

CHAIRMAN VOLCKER. We have stopped the wage increases in government--at least the federal government--for better or for worse.

MR. ANGELL. The next step is that, over a period of time, the private services sector is going to adjust those rates of inflation to the others, as soon as they believe them. But how are they going to believe them when our own staff and our own FOMC don't believe the rate of inflation is down? I don't understand how we can lead the way to lower inflation when we keep saying it's going to be higher.

CHAIRMAN VOLCKER. So far it has worked. Mr. Parry.

MR. PARRY. I would favor alternative B for many of the reasons that were mentioned. I think the possibility of a pickup in the second half of the year is a sufficient condition to recommend alternative B. I would make the point that the assumption under alternative B of the relationship between the economy and the aggregates basically states that we are going to see a continuation of a sharp decline in velocity. And I would just raise the possibility that given this economy, with these interest rates, we could even see the aggregates grow more slowly--which should not be interpreted as a

tightening move. The second point I would make is really a question, since I am rather new at this. Under the operational paragraph, we said last time "maintain the existing degree of pressure on reserve positions." If we were to adopt alternative B, we would say the same thing; but shouldn't there be a parenthetical phrase inserted to say the existing degree of pressure on reserve positions that has persisted since the cut in the discount rate? Because, in effect, if we had cut the discount rate and didn't change the borrowing assumption, we actually would have eased reserve positions. And the historical record--

CHAIRMAN VOLCKER. Well, we have run into that problem before. Let's worry about the wording of the directive on the next round. I think you have a legitimate question. But meanwhile, when you say "B," you are thinking in terms of something like \$300 million?

MR. PARRY. Yes.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I, too, would favor alternative B. As has been mentioned, there are certainly short-term risks, in terms of real economic performance. There are also risks it seems to me, perhaps looking longer term, on the price side; some of those have been alluded to. But productivity performance for the overall economy has been disappointing, perhaps to put it mildly, [unintelligible] the decline in the dollar. I am not at all sanguine about progress on inflation in the services sector, in part because I think we are facing strong and growing demand both for the services produced and for the labor to produce them. And that just doesn't strike me as an environment where we are likely to make a lot of progress in bringing down inflation in that sector. Indeed, I think if we factor those things together--the particular situation in services, the productivity side, the dollar, and so forth--looking longer term we clearly face some risks on the price side. For the time being alternative B, which I would take to be a "don't rock the boat" alternative, is satisfactory. I would be concerned, however, if it turned out under alternative B that the monetary aggregates grew more rapidly than is currently envisioned because, under all the circumstances, I think that might be something we would want to resist.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I would be in favor of "B," but I might also tend a little toward "A" despite the positive tone of the comments regarding the economy earlier. Nevertheless, the current situation is a little on the weak side and though we all expect the longer run to be better, it's a little uncertain. It does seem to me that the longer-run outlook will be validated if we are able to maintain these levels of interest rates. I am just a little bothered by some of the comments with regard to rates that are incorporated in the text around alternative B. So, I would choose "B," but on the borrowing I would tend to want between \$200 and \$300 million as the alternative.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I tend to agree with that statement. My feeling is that I don't see any reason to change sharply from the current reserve maintenance situation. But I would like to have some flexibility at least built in on alternative B with a slightly lower borrowing target, given the way the yield curve looks now and the point made by Steve Axilrod and Peter Sternlight that there has been a discounting already in the market with the spread between the T-bill and the funds rate. And if the Japanese were to cut their rates later for some reason, there might be an opportunity to let the funds rate ease some without any exchange rate implications and without any particular pressures resulting from that. The other problem I have is that I am a little uncertain about this velocity issue. Of course, my concerns are more on the down side. When we met before, we talked a little about a zero rate of velocity growth as the most likely possibility during the year. However, the way things are shaping up during the first half of this year, it certainly looks to me like nominal GNP is going to come in below our earlier expectations. If we maintain the same amount of M1 growth or reserves, I would expect the weakness in velocity to show up more severely than we anticipated. The first-quarter [velocity] looks like it's going to be minus about 2 percent an annual rate; in the second quarter it could even be more than that. I think we are going to see more softness in the second quarter than we have in the first.

MR. PARRY. In alternative B, in terms of growth of the aggregates, M1 is 7-1/2 percent.

MR. JOHNSON. Yes, the velocity was in there; I agree. I am just saying that we are getting a lower nominal [GNP], implying a more negative velocity than we had before. So I guess the issue is: If that lower nominal is all on the inflation side, that's fine; we ought to consolidate our gains to some extent. But I think we ought to be a little careful if we are still seeing the same trend in velocity that we've seen before, since we have had further interest rate declines and inflationary expectation breaks. I don't know what the right amount of reserves is to offset that. I see this as purely technical. I am not talking about an easier policy; I am only talking about a purely technical adjustment. I think we ought to be cautious and we ought to have some flexibility built into alternative B in case we see that develop.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I think this is one of those times when we ought to gear current policy to where we expect the economy to be six to nine months from now. Quite clearly, our expectations in general are as strong as, and in some cases stronger, than the Board staff's projections. So, I think we should stay with our present policy, alternative B. I think the market has overshot the current discount rate, and alternative B probably will require some modest upward adjustments in market rates. But I don't think we should let that trouble us.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. In the context of a consensus view of the economy that we talked about earlier, ironically, I find this a tough setting for monetary policy. I myself am in the somewhat

uncharacteristic position of thinking that in the very short term--the next couple of months--the economy could be on the weaker side simply because I have a bigger allowance for short-run negative oil [effects] than others do. Then again, the point has been made that there are other things in the short run that can be troubling: debt burdens, overbuilding, financial problems, slow growth in the other OECD countries. But when I think about that agenda of things, it is not at all clear to me that any of them is going to be helped very much by easier monetary policy; I could almost agree in a couple of cases that they might be affected adversely by an easier monetary policy--especially if one thinks that the second half of the year is going to be distinctly stronger. That is the rock and the hard place: an economy that could be weaker in the short run and stronger in the second part of the year. I think the only thing to do in that situation is nothing; so I'd be squarely in camp "B."

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I would vote for alternative B and if there is a shading needed, I would shade a touch toward alternative A. The positive factors we have talked about extensively; I am still impressed, though, that there are some drags on the economy that we have to be aware of. I would like to suggest that in a technical way we look for opportunities to cut the discount rate. I am not talking about fiddling with the reserves, but if foreign countries such as Japan alter their discount rates again and if our long-term rates decline a little more, I think we will have a yield structure in this country that is unsustainable. And the rate that will prove to be out of line is the discount rate. To the extent that we could cut that a bit, following market movements, I think that would help without gunning the economy. So, I would go for something like "B" with a range around the \$300 million borrowing target, or \$200 to \$300 million.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I favor a "wait and see" posture and I think "B" is that posture. I think that we really do have the time to watch events unfold. As for the borrowing number, I suppose I am for \$300 million, although we always seem to interpret that in the light of what happens. It has recently been running below \$250 million and I'm for \$300 million but would go at it carefully, which I guess is the way we do it anyway.

CHAIRMAN VOLCKER. I didn't hear that last sentence. Carefully meaning--?

MS. HORN. Going up from \$250 million to \$300 million.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, I am more or less in the "B" camp. I can, however, see the wisdom of at least allowing for a little flexibility toward the "B+" side. I am not sure that flexibility would be wise to use, but I could see a back-up in rates sufficient that that little flexibility might have to be used. Where I come out is "B" to start out with, but keep this little tilt on the shelf. If it needs to be

used, it needs to be used; and if it doesn't, let's just slide through the period with a pretty solid alternative B.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, I would lean toward "B" with a little to the "B+" side. I recognize that fine tuning and so forth is not overly successful, but it does seem to me that at least for the first quarter and the second quarter the economy doesn't look that strong. I recognize there are lags, but we do meet again in May; and I would just lean a bit on the high side of "B" until we have more information, which we will tomorrow and the next day, [or] until we meet here in May. If that subtle move were a mistake, I think it could be undone, probably subtly. I would be slightly in favor of "B+."

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I wish I could be different from everybody else, but I can't. So I am going to go along with alternative B for all the reasons that people have expressed. We want to stay where we are, to do nothing, to maintain an even keel--steady as you go.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. There just isn't any basis for an easing policy right now. Alternative B clearly is in the right ballpark. I am a little concerned about the 7-1/2 percent [M1] number. It seems to me that velocity may be on a different path than we anticipated. In previous periods of history it has been on a downward path for many, many years and changed inflation expectations may very well mean that we've got negative velocity. I'd anticipate negative velocity of more like 4 percent for the second quarter. And if we have 4 percent, I don't know that 4 percent nominal is too high, so I would be much more comfortable with an 8 percent than a 7-1/2 percent on "B." I am not concerned about the reserve positions as long as the Desk is astute, as they have been during the time that I have watched them, in regard to managing that account.

CHAIRMAN VOLCKER. Looking at these velocity numbers, what do you compute for the velocity--I think you do quarterly averages--implied by alternative B, for what it's worth? It is just arithmetic.

MR. AXILROD. It is around 4 percent.

CHAIRMAN VOLCKER. Just looking at it, it looks like what--about a 3-1/2 percent velocity decline?

MR. AXILROD. That's right, compounded. The quarterly average is higher than the month-to-month.

CHAIRMAN VOLCKER. That requires believing both the M1 forecast and the economic forecast, which are two very large assumptions. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I would also join those--virtually everyone that I have heard around the table--who

would opt for alternative B. I am a bit concerned, however, about the discussion of the borrowing level being a bit below the \$300 million level. It seems to me that we are very close to the frictional level now. And to talk about \$200 to \$300 million and \$250 million, for example--. I just feel more comfortable staying where we are; if that is \$300 million, I'd opt for "B" with \$300 million and not fool around with the borrowing level.

MR. ANGELL. Would you want that even if that meant that fed funds rates tick back up?

MR. GUFFEY. The answer, I think, depends on what happens elsewhere. I guess for the fed funds rate in and of itself the answer is yes. I think that the market has probably overshot a bit.

VICE CHAIRMAN CORRIGAN. Are we in a period where seasonal borrowing will start to pick up now?

MR. STERNLIGHT. I think it has begun to pick up just slightly; and I would look for it to pick up somewhat more as we get into--

VICE CHAIRMAN CORRIGAN. In that sense even \$300 million is less than \$300 million.

MR. STERNLIGHT. \$300 million, I think, becomes slightly less constraining.

CHAIRMAN VOLCKER. What is seasonal borrowing now?

MR. STERNLIGHT. About \$70 million, I think, is the last--

MR. AXILROD. Around \$70-\$85 million on average roughly. We would expect it to pick up maybe into the low hundreds or something like that over the next month or so. Without much pressure on the funds rate, we would not expect much of a pickup.

MR. ANGELL. Most of that seasonal borrowing may not recur this year simply because there is liquidity there and the seasonal borrowing privilege has not been used. At least that has been our experience.

CHAIRMAN VOLCKER. What was the peak last year for seasonal borrowing?

MR. AXILROD. My memory is a couple of hundred million or so.

MR. GUFFEY. About \$180 million.

MR. KOHN. August's \$221 million was the monthly-average peak.

MR. GUFFEY. Under the circumstances I think it would be less this year.

CHAIRMAN VOLCKER. Want to add something, Governor Wallich?

MR. WALLICH. \$300 million and alternative B.

CHAIRMAN VOLCKER. You didn't break the pattern.

MR. RICE. The first time I have ever seen that!

CHAIRMAN VOLCKER. Well, we have shadings of differences. We have some full-blooded "Bs" and we have some weak-kneed, but the view is generally around "B." We might as well see what shadings we have here and [address] Mr. Parry's point. The last two reserve periods, which means for four weeks, borrowing has been averaging just a little below \$250 million. We played it a little on the cautious side and it has come out pretty close to where we intended because we didn't have any computer problems and so forth during that particular period. We came in a little under \$300 million. One interpretation is we could continue doing that: seek something like \$300 million, but played somewhat cautiously in the absence of other developments. I guess we could call that maintaining. I don't know whether it needs [explanation]; the difference is so small. We have sometimes done exactly what Mr. Parry suggested, if I interpreted him right. When reserve pressures have changed during the period, we put some language in saying "the degree of reserve pressure that emerged during the previous period" or something like that. I guess it is a matter of taste as to whether that's where the center of gravity lies or whether it's worth putting that in there if the difference is so small.

MR. RICE. I wouldn't say reserve pressures eased after the discount rate; interest rates fell.

CHAIRMAN VOLCKER. Actually, it came before the discount rate lowering, as I remember it, or it began--

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. This is no big deal, because it was so high the previous two-week period because there were computer problems one weekend. We actually had \$600 million one week, but I do not--

MR. AXILROD. It was \$630 million the week of the 19th and [unintelligible] the week of--

CHAIRMAN VOLCKER. The \$630 million was a freak; I don't know where it would have come out without the computer problems. One or two people said they would be reluctant to see the borrowing go below \$300 million and others suggested that at least there ought to be some flexibility to go below \$300 million. These are pretty fine shadings. Let me jump down [in the directive]. I don't know if this language in the directive is great, anyway. Do we want to make it perfectly symmetrical in language in the third sentence? Or would we better capture [the consensus] by changing that sentence to say either "somewhat" or "slightly lesser reserve restraint would be acceptable and somewhat greater reserve restraint might be"? We've used that device from time to time. I think there is a question--we've discussed this before at times, though it wasn't appropriate when we changed the discount rate this time. If for some reason, because of international considerations or otherwise, it seemed appropriate to reduce the discount rate at some point, I take it that the sense right now--other things being equal--is that we might increase the borrowing level a bit rather than the opposite.

SEVERAL. Yes.

CHAIRMAN VOLCKER. I don't think we can write that into the directive.

VICE CHAIRMAN CORRIGAN. When do we meet again?

MR. BERNARD. May 20th--7 weeks.

VICE CHAIRMAN CORRIGAN. Well, my instincts tell me that sentence probably should be symmetrical even though 7 weeks is a long time. I don't think we can rule out the possibility, even though I don't see it, that the economy could pick up even faster than most people are assuming.

CHAIRMAN VOLCKER. I don't think we can rule that out either but it's a question of whether we bias it slightly.

MR. ANGELL. It seems to me the most likely event that might necessitate tightening would be an oil price move; that probably would be more likely in this quarter than robust growth.

CHAIRMAN VOLCKER. An oil price move upward?

MR. ANGELL. Well, yes. And it seems to me that if we had an oil price move upward and it appeared to some that a cartel move might be effective for a while, with the money the public seems to want to hold in transaction balances we might have some wider shift in expectations that might require some tightening. It seems to me we should be prepared for such a policy if that were to occur.

CHAIRMAN VOLCKER. Well, who knows what's going to happen? But I would be a little surprised if that happened in the next 6 weeks or so. I wouldn't be at all surprised to see it happen in a slightly longer time perspective. But suppose it happened in the next month or two. Would the right reaction be initially to tighten a bit? I don't know.

MR. ANGELL. Yes.

MR. JOHNSON. It all depends on the overall long-term inflationary expectation effects of that. If one were to view this as a permanent change back in the direction that causes expectations to have to adjust, those balances people are holding in M1 might turn more into transactions balances relative to savings. And we would want to take it out. But who knows what the behavioral effects would be--whether they'd consider it long-term or short-term? If it really is an inflationary expectation adjustment, we'd have to tighten.

CHAIRMAN VOLCKER. Certainly, over time it would go in the direction of more inflation. You can't escape that. What it would do to the business picture in the shorter run, I'm not so sure.

MR. BOEHNE. I don't think you can anticipate those kinds of things. If there is a definite change in the price of oil up or down we might want to have some consultation over the next seven weeks. It's just a little hard to judge what we'd do. We would have to take a look at the context in which it happened.

CHAIRMAN VOLCKER. Well, I don't disagree with that, and I don't think it's going to happen over this time period. But who knows? Well, let me put it this way: the straightforward thing to do is just to say "maintain" and keep all the wording the same, putting in whatever these percentages are. You can all [react] to that. Who wants to shoot at that?

VICE CHAIRMAN CORRIGAN. I don't want to shoot at it; I'd like to do it.

MR. JOHNSON. Where are you, line 68?

CHAIRMAN VOLCKER. I'm looking at a different sheet where I don't have the line numbers.

MR. BOEHNE. One way to accommodate this idea of a little flexibility would be to reverse the order and say somewhat lesser reserve restraint first followed by somewhat greater reserve restraint. That's very, very subtle but I think we're talking about very, very subtle differences.

MR. GUFFEY. The word is cryptic.

MR. JOHNSON. I don't think the probabilities are symmetric in this thing. I would still be in the "B+" category. I realize that I'm probably in the minority on this, but I wouldn't want a purely symmetric statement that something like a borrowing target of \$200 to \$300 million suits me.

CHAIRMAN VOLCKER. Well, it's hard to object to what Mr. Boehne suggested, and it's hard to object because I don't think it does anything but make a few people feel better. I guess the question is whether people want to go beyond that and just shade it very slightly.

MR. PARRY. Well, the staff has said that the second-half's growth will be 4 percent on average, right? The question then is: Does the group think, if it's going to be on either side of that, that it's more likely to be less than that or more likely to be higher? If I recall the discussion, I think there were only one or two who said they thought growth would be greater than that 4 percent. That might give some indication of lack of symmetry, in terms of the way we discussed it.

CHAIRMAN VOLCKER. We're only talking about 7 weeks. It's a reasonably long period between meetings, but it somehow seems like a very long period. If we get March set and whatever April data we have coming in on the weak side, do we react at all? That's the question.

MR. STERN. Well, as I read that sentence as currently constructed, it allows us to do all sorts of things.

CHAIRMAN VOLCKER. I think you are right.

MR. STERN. I don't see any reason to change it, other things equal. If the numbers on the real economy start coming in very weak, I think we can respond.

CHAIRMAN VOLCKER. I think that's--

MR. JOHNSON. I don't have any strong opinion.

CHAIRMAN VOLCKER. Well, I don't know whether it's worth changing the order to say somewhat lesser reserve restraint or somewhat greater. The numbers we put in here--these are not very rounded numbers. We've been using rounded numbers recently haven't we?

MR. ANGELL. Yes, that's why I'd like to have 8 percent on the M1. I just think that if the economy gets weak in the second quarter we're apt to see the March M1 numbers go the other way.

CHAIRMAN VOLCKER. Well, it might sound slightly more consistent, given the uncertainties expressed, to say 7 to 8 percent for M1; it has the same midpoint as in "B."

MR. ANGELL. Except that it intends to imply a range. And I don't know whether that's--

CHAIRMAN VOLCKER. We've often stuck ranges like that in here, but it's no big deal.

MR. MORRIS. If it really is a range, Wayne, it would have to be a lot wider than that.

MR. ANGELL. That's what I'm saying.

MR. BOEHNE. It's a mushy point when we go to 7 to 8 percent.

CHAIRMAN VOLCKER. Well, 7 to 8 percent just sounds a little better to me than 7-1/2 percent, but it's no big deal. The difference between 7-1/2 and 8 is not very great; neither is the difference between 7-1/2 and 7.

MR. ANGELL. But with the staff's estimation of a negative 3-1/2 percent velocity, that means we want a self-fulfilling prophecy of 4-1/2 percent or 4 percent nominal and that's not much.

CHAIRMAN VOLCKER. No, no. This converts into a 9 percent or so quarterly average. If that's the way you measure velocity, which is the way they measured velocity, you'd get 3-1/2 percent negative velocity consistent with these numbers because the quarterly average is higher. You're starting high.

MR. JOHNSON. Consistent with 7 to 8 percent?

CHAIRMAN VOLCKER. Yes. Well, I said it comes out over 9--

MR. AXILROD. That's right: 9 percent quarterly average as against the--

MR. ANGELL. What comes out at 9 percent?

CHAIRMAN VOLCKER. The quarterly average measured growth of M1.

MR. ANGELL. Okay.

CHAIRMAN VOLCKER. While we're picking at these numbers, is it worth saying 7 percent for M2 and 6-1/2 percent for M3 or should we say 7 percent for both of them?

MR. GUFFEY. 7 percent for both.

MR. MORRIS. About 7 percent.

CHAIRMAN VOLCKER. About 7 percent, unchanged. Well, I would suggest that we say "maintain" and note in the record that reserve pressures have eased a trifle during this period. We expect this "to be consistent with growth in M2 and M3 over the period from March to June at annual rates of about 7 percent; while the behavior of M1 continues to be subject to unusual uncertainty, growth at an annual rate of about 7 to 8 percent over the period is anticipated. Somewhat lesser reserve restraint or somewhat greater reserve restraint might be acceptable depending upon the behavior of the aggregates." I would interpret this as \$300 million [on borrowing], but play it somewhat cautiously in the actual provision of reserves. We anticipate a little more to ease than we anticipate to drain.

MR. GUFFEY. I hate to ask this question, Mr. Chairman, but I assume that the latter implies a 7-1/4 to 7-3/8 percent funds rate or thereabouts.

CHAIRMAN VOLCKER. In the absence of other [unintelligible] I don't see why it implies any change. Although historically I think it would have implied a lower federal funds rate relative to the discount rate, it doesn't seem to these days.

MR. ANGELL. Well, it seems to me that if M1 and the other aggregates were on a higher path than we anticipate, we could accommodate some upward move in the fed funds rate. If it's lower than we anticipate we ought to accommodate some downward movement. I don't think we should pinpoint the fed funds. It seems like--

CHAIRMAN VOLCKER. It's consistent with what this says.

MR. ANGELL. Yes.

CHAIRMAN VOLCKER. The only thing I would ask is: How much weight do we put on those rather short-term changes in the aggregates compared to what information may be coming in simultaneously on the economy or whatever.

MR. ANGELL. Put "together with."

CHAIRMAN VOLCKER. Pardon me?

MR. ANGELL. Together with.

CHAIRMAN VOLCKER. Well, that's precisely what this says. Is that as close as we're going to come? We have a funds range--well, wait. I was about say 6 to 10 percent for the funds range. Is the funds rate low enough so that we want to change that?

MR. JOHNSON. Well, the Bluebook has it a little different.

MR. AXILROD. We're suggesting the possibility of--

CHAIRMAN VOLCKER. What did you say on "B"?

MR. AXILROD. We said 5-1/2 to 9-1/2 percent; that gets a little closer to centering it.

MR. BOEHNE. How about 5 to 10 percent, since we--

MR. JOHNSON. 5 to 10 percent isn't in the range of belief.

MR. BOEHNE. Neither is 6 to 10 percent, but--

CHAIRMAN VOLCKER. I have the feeling we should just leave it at 6 to 10 percent because that's where it has been for a long period of time or change it to 5 to 9 percent. I just think that--

MR. MELZER. Leave it 6 to 10 percent.

MR. JOHNSON. 5 to 9 percent centers it on where it is now.

MR. RICE. We're not making any change, so why move it? That's going to confuse people.

CHAIRMAN VOLCKER. It doesn't make a lot of difference. This has no practical significance except a month or so from now when it is published some newspaper article will say the Federal Reserve eased.

SEVERAL. Yes.

MR. MELZER. I wouldn't change it for that reason.

CHAIRMAN VOLCKER. How many want to leave it 6 to 10 percent? Eight, and those are all Committee members. I guess the consensus is to leave it 6 to 10 percent. I don't think it will change anything. All right. With that, I guess we're ready to vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
President Horn	Yes
Governor Johnson	Yes
President Melzer	Yes
President Morris	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. We have this rare event. I don't think a unanimous vote is all that rare but by 10 minutes after 12 it is pretty rare. And the lunch is set for 1 p.m. Well, I don't know whether there are any other burning issues to be raised at this time. The Open Market Committee meeting is over.

END OF MEETING